View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Asian Journal of Multidisciplinary Studies (AJMS)

Asian Journal of Multidisciplinary Studies

ISSN: 2321-8819 (Online)
2348-7186 (Print)
Impact Factor: 0.92
Volume 3, Issue 3, March 2015

Private Equity (PE): Implications for India and Regulatory Issues

Krishna Singhal[1], Komal Singhal[2] and Monika Arya[1]
[1]Assistant Professor, Bharati College, University of Delhi, New Delhi, India
[2]Assistant Professor, Kalindi College, University of Delhi, New Delhi, India

Abstract

Private Equity (PE) is the money invested in companies that are not publicly traded on a stock exchange or invested as a part of buyouts of publicly traded companies in order to make them private. PE investors do not expect return in the form of dividends rather they gain out of share price appreciation. This return is realized at the time of exit from the investee company.

Since at the inception stage of a company, there is a limitation on the availability of other sources of finances i.e. debt instruments or bank finance, requisite finance can be provided by private equity. Further, since investments are made in illiquid assets i.e. companies, money gets locked up for a long period and redistributions are made when the investments are converted into cash.

With Indian economy recording about 8-9% GDP growth, a buoyant capital market, sensex hovering at around 17000 – mark, improvements in industrial growth and rising exports, India is becoming a leading destination for PE investors.

The present paper makes an attempt to look into these aspects. It also deals with the existing multiple regulatory framework and the tax aspects of capital gains arising out of PE investments. It enumerates the impediments in the development of PE investments and also throws light on how the scope of PE investments can be improved by making standalone regulations.

Keywords: Equity Capital, Financing, Investment Banking, Venture Capital, Merger & Acquisition, Government Policy & Regulation, Business Tax

JEL Code: E22, G24, G28, G32, G34, G38, H25

Introduction

A new class of financial intermediaries such as private equity (PE) and Venture Capital has emerged due to the integration of financial markets of all countries of the world & increasing risk appetite among the global investors. PE industry is a probable source of finance for the cash strapped small and medium enterprises. By identifying companies with untapped potential and restructure their operations in ways that increase their value, PE industry has made its presence felt in the world economy. India has become a major destination for PE investors due to its 8-9% GDP growth, high gross domestic market, buoyant capital market, improvement in industrial growth and rising exports. Given their rising importance in the financial sector, there have been concerns about their regulations. The reticent nature of PE firm activity, restricted research and lack of regulatory controls on the PE industry have raised several questions about the quality of capital flowing in via PE route and the possibility of systemic risks emanating from the operations of PE funds. The present paper makes an attempt to look into these aspects.

Meaning of Private Equity (PE)

PE means investing in companies that are not publicly traded or investing in a publicly traded company with the intention of making it private. Private equity funds generally put money in illiquid assets i.e. companies. By purchasing companies, the PE firms gain opportunity to approach to those companies' assets and revenues, which can lead to very high returns on investments. PE firms also make substantial use of debts to finance acquisitions and thereby increase their financial returns signifcantly. The debt used in buyout has a fixed cost so if PE funds' return on investment (ROI) is greater than its debts' cost; its return on equity (ROE) is higher. The same principle applies in reverse also, making these leverage buyouts very risky.

PE is also called 'patient capital' as it attempt to achieve profit from long term capital gains instead of short term regular reimbursements. PE investors expect gain from share price appreciation rather than expect return in the form of dividends. This return is realized at the time of exit when they either sell the company to another private entity or return it to the public markets, probably for a price

higher than they paid originally. Therefore, PE investors prefer to make investments where a clear exit plan has been created.

Major Financing Activities undertaken by PE firms

The PE firms provide finance to companies at different stages of corporate development such as -

1. Seed financing: It means providing small sums of capital required to originate a business idea.

2. Start-up financing: It means providing capital required for development of a product and initial marketing activities.

3. First –stage: It means providing finance for the commercialization and production of products.

4. Second-stage: Providing working capital funds to young firms during growth period.

5. Third-stage: providing finance for the expansion of companies.

6. Bridge Financing: Last financing round prior to Initial Public Offer.

Major Investment Strategies followed by PE Firms

PE firms can adopt any of the following investment strategies in their action plans-

1. **Leveraged Buy Out (LBO)**: LBO refers to the strategy of making equity investments in a company with the use of financial leverage. It involves a financial sponsor agreeing to an acquisition without itself committing all the capital required for acquisition.

This kind of financial leverage helps the financial sponsor in two ways: (1) the investor is required to provide a fraction of capital for acquisition and (2) the return to the investor will be increased as long as return on assets is more than the cost of debt.

2. **Venture Capital (VC)**: VC refers to equity investments made in young upcoming companies for launch, early development or expansion of a business. Entrepreneurs require substantial capital in order to develop products and ideas during the formative stages of their companies' life cycles but they do not have sufficient funds to finance the projects themselves and therefore seek outside financing. Venture funding is an expensive capital source for companies as Venture capitalist's need to provide high return to compensate for the risk in these investments.

3. **Mezzanine Capital**: It is a form of financing that is part debt and part equity and therefore holds a middle position in a company's capital structure. It ranks behind senior bank borrowings but ranks ahead of equity investors' dividend, sale and liquidation claims. It incorporates equity based options, such as warrants with a lower priority debt, to provide flexible long term capital for use in buyout or growth financings. Frequently unsecured, it usually bears interest at a higher rate than secured loans and often gives the lenders a stake in the equity of the company. Its repayment profile ranges from 5 to 7 years.

4. **Growth Capital**: It refers to equity investment, most often minority investment, in relatively mature companies that need capital to enlarge or restructure their operations, to enter new markets or finance a major acquisition without a change in control of the business. By selling part of the company to PE, the owners can take out some value and share the risk of growth with partners without forgoing management control. Companies use this capital to restructure its balance sheet, particularly, to reduce the amount of debt the company has on its balance sheet.

Private investment in public equity (PIPE) refers to a form of growth capital investment made in publicly traded companies. PIPE involves selling of publicly traded common shares or preference shares or convertible debts instruments to private investors.

5. **Distressed Capital**: Distress investing involves purchasing equity or debt securities of financially stressed companies that have either filed for bankruptcy or appear likely to do so in near future. They are sometimes referred to as "vulture capitalists" because of their quest for seeking out highly troubled companies. They make their returns not by liquidating a company, but by nursing it back to health. Distressed debt firms typically employ people with expertise in effecting "workouts," or company turnarounds. When the emergent company improves its financial performances and re-gains credibility in the marketplace, distressed debt firms stand to profit.

Players in PE Market:

1. **Issuers** are the entities where PE invests. They also called Target Company, Host Company or Investee Company. As PE is an expensive source of finance, issuers are the firms that do not have access to bank loans, private placements or public equity market.

2. **Intermediaries** are the General Partners (GPs) who run the PE funds, provide expert professional services, perform due diligence and in return charge fees. They evaluate the quality of management team, keep track record of target company and take care of the regulatory issues.

3. **Investors** are the Limited Partners (LPs) or the providers that provide capital to the PE fund. These include pension funds, investment banks, insurance companies, wealthy families or high net worth individuals. Investors are inclined to contribute capital to PE funds because they expect the risk adjusted return on PE to be higher than returns on other investments and also to derive benefits of diversification.

Business Cycle of PE

1st Stage or Pooling Stage: In this stage an investment fund (GPs) is established that collects funds from institutional investors or LPs.

2nd Stage or Investment Stage: Capital thus collected is used to buy equity stakes in high potential companies. PE firms generally make investment in juvenile growth stage of issuers.

3rd Stage or Exit Stage: PE funds generally do not intend to maintain indefinite control over the target company. Instead they try to acquire a company with a view to implement value added changes and then realize the capital gains by disposing off their investments in the span of 3-5 years.

4th and Final Stage: Finally, capital recovered from the exit is redistributed to LPs or original investors on pro rata basis depending on the size of their original investment.

Exit Routes

Exit Routes	Meaning
1. Listing of shares	This is a preferred exit route for industrial, infrastructural and financial services in India. It enables free transfer of securities in the open market.
2. Sale to strategic investors	This involves sale to any acquirer interested in taking over management of the company and is a preferred route for consumer goods sector in India.
3. Merger with listed company	Investee company gets merged with other listed company, enabling free transfer of shares.
4. Auction of shares	PE investors may sell their stake in the open market by way of auction.
5. Buy back of shares by company or promoters	Company/promoters use buy back process to purchase the holdings of PE investors complying with the provisions of Companies Act, 1956.
6. Management Buy Out	The managers of a company purchase controlling interest in the company.

Investment Vehicles:

PE firms invest in one of the four investment vehicles:

Investment Vehicle	Meaning
1.Direct Investment Funds	In this case, investors directly invest in issuers' company
2. Funds	In this case, GPs accumulate funds from LPs and handle about 10-20 investments on their behalf.
3. Funds of Funds	Here, investment is made in a fund whose primary activity is investing in other PE funds. This model is used by investors looking for diversification and exposure to difficult to reach/ emerging markets/top performing funds etc.
4.Collaterized Fund Obligations	In this case, securitization is made against PE funds invested.

Evolution of PE in India

The history of private equity in most of the South Asian regions started with venture capital firms which later graduated into the PE firms by widened their area of activities. The seeds of Indian PE firms were laid down in the mid 80's when ICICI, IFCI, IFCI, Canara Bank and various other regional companies in Gujrat and Andhra Pradesh promoted venture capital companies. In late 80's and early 90's, various private sector funds also came into being. Many foreign PE firms like Baring PE partners, CDC Capital, Draper International, HSBC Private Equity and Warbug Pincus also started coming during 1995-2000. The focus of PE investors' further shifted from developed economies to the Asian market particularly India due to global downturn. While recession and adverse credit conditions continued to curtail investment activity in US and Euro continent, the Indian economy came out of it very quickly just by 2nd half of 2009.

Currently, both international and domestic PE funds have presence in India. But nearly 80% of the money committed to India during the past two years has originated from foreign resources. Others are sponsored by seasoned domestic business houses such as Aditya Birla Group, Reliance Industries, Future Group and TVS Group that have earmarked capital for investment in India through PE and VC routes.

In India, it was Bharti Airtel – Warbug Pincus private deal which encouraged further private equity activity in India. From this deal, Bharti Airtel received $292 million over a two year period ending September 2001. The fund so collected made it possible for Bharti Airtel to expand its business from just two mobile telecom circles (Delhi and HP) to 23 circles in 2004. Warbug not only provided capital but also strategic inputs and mentored its management team. The exiting process of Warbug started in August 2004 and completed it in October 2005 securing total gains of whopping $1.3 billion in the sell off.

Another notable PE success story lies in the Non Banking Finance Company field. The 'Shriram Transport Finance Corporation' is a vehicle finance company that selected for private equity capital

from ChrysCapital and TPG Newbridge in 2005. It helped the company build a global outlook.

Similarly, in a recent deal concluded in December 2010, Actis and Squoia Capital sold their shareholdings in Paras Pharmaceuticals to Reckitt Benckiser Group, a UK based company by earning a return of 4.5 times of initial investment and that too in just 4 years!

Sectoral Wise Analysis of PE Investments in India

Private Equity has been flowing mainly into banking and financial services, construction & real estate, telecom, manufacturing, media, pharmaceuticals and entertainment sectors.

(PE Investment in India during 2007)

Sector	% of total PE	Remarks
Finance	24.9%	75% investment of PE firms in that sector is of foreign PE firms. Most of the deals were PIPE deals
Telecom	16.3%	With 2Gs- lot of investments were made by PE firms and over 70% of investment were made by joint ventures between Indian and foreign private equity firms
Construction and Real Estate Sector	13.4%	Mostly by foreign PE firms and through PIPE deals
Manufacturing	12.3%	In manufacturing sector PE investment recorded a decline over 2006 due to adverse impact of global financial turmoil.
Others	33.1%	Energy, information technology, media & health care were the other sectors attracting PE funds

(Source: RBI Occasional Papers, Volume 30, No.1, Summer 2009)

Benefits of PE Finance:

PE finance has become popular in recent times as it provides various benefits to the companies concerned as well as the industry, economy and society at large. Various benefits accruing from the PE investment include:

1. Optimizing company's capital structure: PE supplements traditional sources of resource mobilization such as public equity issues, private placements, euro issues and external commercial borrowings etc.

2. Medium enterprises find it difficult to raise debt finance, for them PE is a vital source of finance.

3. General management guidance at board level- PE firms bring in best management practices by exercising influence over the board of directors . PE investors are generally interested to invest in companies that follows good corporate governance practices, transparency in financial disclosures, sound internal control and fair accounting practices. They also advise in recruiting the best managers to run the business as they have experience in diverse fields. In particular, induction of professional and independent members is always advisable where the board consist of mainly the family members.

4. Helps in retaining control by the promoters: Through PE, a company can raise capital without renouncing operational control to external shareholders. It is the only class of investors who have the ability, expertise, track record and willingness to add value without any ultimate control desires. Nevertheless, PE firm does retain some control such as ability to influence the composition of management teams.

5. Helpful in R & D Projects: Sometimes a company need a large amount of capital for long term productivity investments such as R&D. Rather than waiting several years to gather sufficient capital, the company may choose to sell part of its interests to PE in exchange for the ability to pursue development projects. This may be especially true of highly time sensitive industries such as software, telecommunications and internet services where a few years may make a critical difference in a company's ability to gain a market advantage.

6. Marketing Benefits to host company : (a) Gains from GP's international network of contacts and injection of technical know how (b) Improvement in its business processes due to PE-induced discipline and restructuring of inefficient systems (c) Clearcut mapping of company's growth trajectory and prioritizing critical business initiatives (d) Speeding up of product commercialization (e) Better marketing of products (f) Enhanced brand image (g) Ease in forging strategic alliances

7. Provides social benefits such as improving environment, building infrastructure and upgrading human capital by way of providing employment and higher wage growth. Presently, roughly 40% of all PE investments in India are now targeting infrastructure projects.

8. PE firms are known as natural system stabilizers. During a systemic crisis, other investors may take their money back but PE firms, being long term fund provider, stay with the target company.

9. Provides higher valuation to the investee company in normal stock market conditions. PE can boost a company's stock price, if people think a buyout is likely. Companies that are perceived as likely targets of PE buyouts have seen their stock prices rise in anticipation because investors feel that PE firm will pay a hefty premium over a company's market value.

10. Increase in PE deals has actually benefited some aspects of the stock market. With increase in the PE deals, the availability of publicly traded shares of such companies decreases causing the remaining shares to witness increase in price. As there are fewer shares floating in the market, each becomes more valuable.

However, unbridled PE could prove disastrous for the economy. In the past 10 years, the record of most expensive buyouts has been broken and rebroken several times. PE firms have been acquiring companies left and right paying sometimes shockingly high premiums over these companies' asset value. The sheer number of these high priced deals has led some to question whether this pace is sustainable in the long run.

Further the lenders to PE firms are stuck with high yield bonds that investors are reluctant to buy. Leading bankers like Bank of America, City Group, JP Morgan are sitting on over dollar $40 billion in unsellable debt. This sends wrong signals in the economies making markets volatile and investors panicky.

There have been certain apprehensions about the failure of big size PE funds which mainly deal in leverage buyouts and also the probability of panic selling among PE firms which may worsen the environment. But these apprehensions are unwarranted because investors in PE fund are institutional investors and/or high worth individuals who invest on long term basis and do not exit at the time of volatility in the market..

Impediments in the development of PE Funds in India

For PE to deliver its full potential, both promoters and PE investors need to align their interests. Promoters should stop regarding PE as a last-resort source of capital or opportunistic pre-IPO short term funding option. Rather they should consider them as a partner helping the company outperform its growth goals. PE owners should also recognize that they need to do more to build their brand with promoters. PE investors still play an advisory role and monitor their investments periodically through management reports, meetings and sometimes a seat on the company's board. Beyond that consultative role, more active participation on behalf of PE is needed.

Further PE is not a preferred funding source by a large cross section of promoters who prefer to raise capital through IPOs/ FPOs which they perceive to have less operational constraints. Therefore, eventual emergence of a healthier and more mature PE industry hinges on overcoming impediments in the following key areas:

1. Expectation mismatch over asset valuations: Both promoters and PE investors need to bring about closer alignment of their expectations over asset valuation. Further, high price to earning multiples India's PE investors pay put India in a disadvantageous position compared to China, where deals at single-digit multiples are still available.

2. India's debt and equity market is more open and approachable than they are in China. Therefore, compared to PE, debt and equity compositions occupy more space in capital structure of Indian companies.

3. Macroeconomic uncertainties such as mounting inflationary pressures and lack of political will discourage PEs looking forward to India. Very recently, we saw how the government withdrew in the case of FDI in retail sector.

4. Scarcity of talent: In India, experienced investment professionals are relatively scarce and most PE firms currently operating in India are not more than five year old. They have yet to get the experience of complete deal cycle from entry to exit.

5. Opaque tax laws and multiplicity of regulations governing PE funds: There is no clarity and consistency among various regulations and the tax regime. There are no clear cut rules prescribing the treatment of gains arising from PE transactions.

6. Investors are require to obtain approvals from central, state and urban authorities according to Three tier governing structure in India whose jurisdictions often overlap. For example, developing a power plant in India requires approval from more than a dozen departments from the local to national level.

7. Pension funds are restricted to invest in PE and VC funds. Further, at present, insurance funds can only invest in infrastructure sectors, which is a big impediment in the development of domestic PE and VC funds. Insurance sector should be allowed to invest in other sectors also.

8. SEBI Pricing Norms : In India, PE funds and similar funds find it attractive to invest in those companies whose market prices are lower than what they were few months back. However, the SEBI minimum pricing norms as set out in Chapter XIII of the SEBI (Disclosure & Investor Protection) Guidelines, 2000 are hampering deals in these market conditions.

Why Regulation of PE Market

1. In USA, regulations for PE investments were tightened after terrorist attack of September 11,

2001. As dealing is with PE firms and not with the original investors, there are chances that original investors may belong to terrorist groups. Regulatory framework is therefore considered necessary for filing of detailed returns by PE firms clearly showing the name of original investors and their exposures.

2. After sub prime crisis, even in EU countries, demands have been made to regulate PE funds specifically on the following issues:

(a) Setting limits on debt levels in leveraged buyouts

(b) Measures to contain asset stripping of portfolio companies by PE owners

(c) Greater transparency & disclosure norms instead of voluntary "Code of Conduct"

(d) Greater capital adequacy requirements

(e) Restriction on easy securitization of leveraged loans which have fuelled both the buyout boom and financial crisis.

3. PE has been a secretive economic sector. Unlike mutual funds, it operates privately and does not provide accounts of what it does and how it is done. Due to limited disclosures, studying the returns to PE is relatively difficult. Since they invest in private companies, it is difficult to examine the underlying investments. It is very difficult to compare PE performance with public equity performance as PE fund investments are drawn and returned over time. Further any such analysis may actually overstate the PE returns because it relies on voluntarily reported data and hence suffers from survivorship bias i.e. funds that fail would not report data.

Conclusion

Investments made by PE firms is an important source of finance that bring an essential capital for private and small companies which may have the potential to expand and which may be doing business in the sun-rise sectors, viz. nuclear science, nanotechnology, business media etc. PE firms have tremendous financial clout and on the strength of their huge strategic investment in companies, they ensure greater transparency in company's working, compliance procedure and above all uphold corporate governance principles while doing sound business. For a capital-scarce country like India which has tremendous potential to join the ranks of global super powers, PE firm shall act as a catalyst to fund the infrastructure and economic development plans of the country. But multiple regulatory norms and complex tax laws should be replaced by conducive and standalone regulatory norms for PE funds and simple and non discriminatory tax laws.

References

Bain & Company (2011), "*India Private Equity Report 2011,"* Indian Private Equity and Venture Capital Association, New Delhi.

Chandra, Prasanna (2011), "*Financial Management: Theory and Practice*," Tata Mcgraw Hills Education Private Limited, New Delhi.

Jain, R.K. and Indrani Manna (2009), "Evolution of Global private Equity Market: Lessons, Implications and Prospects for India," *RBI Occasional Papers Vol.30 No.1 Summer 2009*.

Patel, Nishant K (2010), "Private Equity: An Overview," *The Chartered Accountant, Vol.58 No.11 May 2010*.